TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Update on Federal Legislation	ITEM NUMBER: 7b
	ATTACHMENT(S): 1
ACTION: X	DATE OF MEETING: April 2, 1998
INFORMATION: ____	PRESENTER: Ms. DuCray-Morrill

Attached is a comprehensive report from Hogan & Hartson on issues at the federal level. Ms. DuCray-Morrill will provide a verbal presentation at the meeting.

**MEMORANDUM FOR
THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM**

Washington Monthly Report

Mandatory Social Security

There are storm clouds on the horizon as the U.S. General Accounting Office (GAO) wraps up its study of mandatory Social Security. The GAO report apparently will conclude that mandating all new State and local government hires into Social Security will produce a significant revenue gain on the Federal side to the Social Security trust fund, with only relatively modest "downside" impact for existing State and local retirement systems.

With an eye to the approaching House Ways and Means Subcommittee hearing on mandatory Social Security and the indication that GAO was finalizing its study, we arranged a meeting with the GAO study team for CalSTRS, CalPERS, Ohio STRS and PERS, and other interested plans. The purpose of the meeting was to review the GAO's tentative factual findings and discuss factual issues. We met for about an hour and a half.

The GAO study team has finished gathering data and has prepared early drafts of the study which are circulating internally for review. GAO will testify at the upcoming House Ways and Means hearing with a written statement that is effectively the outline of the report. While the GAO team indicated that the GAO study will make no recommendations, as described below the study will deliver a relatively clear message. The study is expected to be in the form of a "letter report" that is briefer than the traditional full-blown GAO report, coupled with possible appendices. This briefer form of the report may make it more difficult to delve into the broad range of potential adverse impacts of mandatory coverage (*e.g.*, the effect on capital markets if new State and local plan assets no longer were flowing in at a multi-billion dollar clip) and is likely to preclude any meaningful review by outside interested groups prior to final release.

As described in previous Monthly Reports, the mandate of the GAO study has been to focus on the various impacts that mandatory coverage of new hires would have on State and local retirement systems, employers, and employees. The framework of the GAO study appears to have effectively become one of measuring the balance between the revenue gain to the Social Security trust fund on the Federal side and the adverse impacts on the States.

The GAO team seems to have started from a premise that is almost insurmountable for the State and local government community -- that Social Security should properly be viewed as a social insurance and social welfare program with strong redistributive elements that as a matter of equity all Americans should bear the burden of funding, rather than being viewed as simply a retirement annuity program. According to GAO, one-third of Social Security funds go to disability benefits, dependent benefits, and benefits for nonworking spouses. In addition, Social Security provides much higher levels of income replacement for lower-wage workers. So, the argument runs, all Americans should fund the social insurance and social welfare benefits. The GAO team seemed to concede that they have not pursued a comparison of Social Security and State and local coverage from a retirement policy perspective, namely whether State and local employers and employees would fare better under the existing State and local plan structure or under Social Security in terms of effectiveness in providing retirement benefits.

Close beneath the veneer of this social insurance hoopla, however, is the true driving force from the Federal side: the revenue pick-up for the Social Security trust fund. As reported previously, the Social Security Administration has estimated that mandatory State and local coverage produces a 10 percent reduction in the long-term deficit of the Social Security trust fund. The GAO staff now indicates that mandatory coverage by itself is projected to extend the solvency of the Social Security trust fund for an additional three years. GAO reportedly is planning to present a potentially explosive chart at the Ways and Means hearing that will show the Federal revenue pick-up from mandatory coverage dwarfing any benefit obligation to State and local workers for decades into the future. In addition, GAO will be pointing out that 95 percent of all employers nationwide are presently covered, along with the employees participating in 70 percent of all State and local retirement systems.

All of this could well undermine the little pull that we have left with the majority of the Members of the House Ways and Means and Senate Finance Committees whose State and local workers are generally covered by Social Security. The non-Social Security States could be cast as the hardy few hold-outs unwilling to bear their burden of contributing to the social insurance arrangement as well as constituting a potential source of significant revenue that could help fund a comprehensive Social Security fix, revenue that could ameliorate some of the more politically explosive changes (*e.g.*, moving the Social Security retirement back further and faster) otherwise necessary in a comprehensive reform package.

The more cynical among us might put things somewhat more starkly. As an historical matter, States were originally kept out of Social Security at a time when Social Security recipients were drawing out more in benefits than they had contributed. Now that this position has reversed, and according to GAO the "normal cost" of Social Security benefits is less than the 12.4 percent payroll tax contributions taken in, the Federal Government is eager to sweep in the remaining State and local workers and employers and let them share equally with the other 95 percent in this "bad deal".

Even the less cynical among us could take issue with the substance of this touted revenue "pick-up" on the Federal side. The gain to the Social Security trust fund is said to take the form of a cash flow matter and an asserted time-value-of-money matter. The argument is that because of the relative youth of the State and local new hires being mandated into the system, Social Security will collect decades of payroll tax contributions from these new entrants before any retirement benefits come due. The Social Security trust fund, it is said by GAO, will enjoy the miracle of compound interest on these revenues before benefits become payable.

Upon closer examination, this argument has a very hollow ring. True, the present surplus in the Social Security trust fund does earn interest. The surplus is invested in U.S. Treasury obligations. However, the interest on those Treasury obligations is not paid in real money, but rather in the form of additional Treasury obligations. In effect, the cash that is pouring into the Social Security trust fund to provide future retirement benefits for the Baby Boom generation is flowing right back out to fund spending on current Federal programs, being replaced by Treasury debt that will have to be redeemed by future generations' taxes. That is why, if the Social Security trust fund were taken off-budget from the overall Federal budget, the impending "surplus" would promptly evaporate, giving way to a sizable current budget deficit.

Thus, unlike the true miracle of compound interest currently enjoyed by CalSTRS and other State and local retirement systems from investing in private equities and debt which produce economic return in the form of real money, the "miracle" of compound interest that is said to be the great boon to the Social Security trust fund from mandatory coverage simply takes the form of cascading Treasury debt the redemption of which will depend on the willingness of future generations to pay additional taxes and forego current consumption.

As noted above, the overall GAO study framework appears to be one of examining the balance between Federal gain and State disadvantage. While the GAO study will acknowledge the cost impact on the States, we fear that this adverse impact will seem tepid by comparison to the rosy Federal revenue pick-up scenario. As to current participants in State and local retirement systems, GAO states there should be only "situational impacts". That is, GAO has concluded that for systems using entry age normal cost funding, there will be an adverse impact only if the plan has an unfunded liability that is being amortized with the help of contributions from new entrants. As to new hires, State and local employers and retirement systems will face the choice of increased costs or decreased benefits or some mix of the two. The GAO report reportedly will acknowledge that mandatory coverage will result in a cost increase in the range of 6-7 percent of payroll in order for the State or local retirement system to provide the same level of overall retirement benefit under coordination with Social Security for new hires.

The GAO report also apparently will recognize that the non-Social Security States could well mount legal challenges to being mandated into Social Security. Such a threat seems unlikely to hold much sway with Members of Congress. Finally, the report will note the administrative costs and problems that would arise to State and local governments. However, rather than serving as an argument against mandatory coverage, this set of administrative concerns seems to be viewed by the GAO staff as merely one of transition, with GAO recognizing that the shift to mandatory coverage could not be accomplished “overnight” and could take “several years”, particularly in light of the biennial schedule of some legislatures.

These are threads of the GAO report that have emerged from discussion. An overall impression of the outcome on the mandatory coverage issue must await the GAO Congressional testimony and the full report. However, the direction of the study seems to be one that could well further isolate the remaining non-Social Security States as the hearty few “hold-outs” who should step forward and properly bear their responsibility for the Federal social insurance arrangement and join with the 70 percent of other State and local systems whose members participate in Social Security without the sky having fallen in.

If in the end the GAO study weakens some of the key historical arguments that the non-Social Security States have used, it will fall more than ever to the political plane to stave off mandatory coverage. It could well take virulent opposition from key Members of Congress from non-Social Security States -- and in turn from top elected State and local officials and employee groups -- to keep mandatory coverage off the table as any comprehensive Social Security reform package is put together, which could begin next year. Once included along with other “haircuts” in a comprehensive reform package, a mandatory Social Security provision could prove very difficult to knock out.

The employee groups must put aside their differences to join with management on this issue and should temporarily suspend or at least dramatically downplay their efforts on the windfall and spousal offset issue, in order to focus on staving off mandatory coverage in the first instance. (Mandatory coverage is of course the most complete solution to the offset issue, and the GAO report reportedly will make that point.)

The public safety groups have been among the most active in opposing mandatory coverage in light of their early retirement history. It was interesting to note GAO's point that public safety and teachers are the two most prominent occupations in the non-covered group. Down the road, as Congress proceeds with any substantive consideration of the mandatory coverage issue, we should be wary of any legislative attempt to split the opposition by providing a special carve-out for public safety justified on the basis of its unique work history. There is ample past precedent in the Federal pension tax rules for special treatment of the public safety occupation.

On the Congressional hearing front, the House Ways and Means hearing date may be slipping. Although the hearing has been tentatively scheduled for March 26 and possible public sector witnesses tentatively identified, witness invitations have yet to be extended and time is running out for travel schedules and preparation of testimony. We will continue to monitor developments on this front and keep STRS staff advised.

Elk Hills Appropriation

We are continuing to work with key Californians in Congress to actively pursue the appropriation necessary to fund the first $36 million installment of compensation due to the State for its interest in the Elk Hills Naval Petroleum Reserve under the State's settlement with the Federal Government.

We prepared and after consultation with STRS staff filed the enclosed statement regarding the Elk Hills compensation issue with the House Interior and Related Agencies Appropriations Subcommittee. In addition, Attorney General Lungren wrote the enclosed letter to Subcommittee Chairman Ralph Regula (R-Ohio) in strong support of the State's position.

The key hurdle to be overcome right now is the budget scoring hurdle. Sales proceeds of $3.65 billion have come into the Federal Government from an outside source. The Federal Government will save $84 million in the coming year from no longer having to operate the oil field. As Congress directed, $324 million has been set aside in a special fund for the payment of compensation to California. However, because of arcane budget scoring rules, at least for now the Elk Hills compensation payment is being treated as a new spending program that must compete for funds under the overall spending caps with the budgets of existing programs under the jurisdiction of the Interior and Related Agencies Appropriations Subcommittees in both the House and the Senate.

Thus far, both the House and the Senate Interior Appropriations Subcommittees have shown a reluctance to invade other programs to fund the California settlement, particularly because these Subcommittees received no "credit" under the budget scoring rules in crafting their piece of the Federal budget for the $3.65 billion in sales revenues that the Federal Government received for

Elk Hills. Rep. Bill Thomas (R-Bakersfield) already has talked to House Budget Chairman John Kasich (R-Ohio) as well as to others in the House Leadership to remind them that there was "a deal" for the State to receive its compensation, that the State has followed the process Congress laid out and has honored its commitment, and that now is the time for the Federal Government to honor its commitment to the State.

At this juncture, it seems likely that strong Member-to-Member contact will be required to resolve this budget scoring and appropriations problem. We will continue actively working toward this end and keep you advised. Rep. Thomas continues to deserve the strong support and appreciation of STRS and all of its members for his continuing hard work to ensure that the State gets its money.

Tobacco Settlement

The Senate has begun actively working on drafting the overall components of the legislation necessary to implement the tobacco settlement. Senate Minority Leader Tom Daschle (D-S.D.) recently noted that until recently the tobacco settlement issue "looked so large and so difficult to confront in legislative and policy terms, that people didn't know how to get a grip on it. Now that we have bills, and people are proposing ways to grip it, the possibility of some solution is becoming more believable."

The key issues continue to be the amount of the per-pack tax "hit", the amount and nature of limits on the cigarette makers' legal and financial exposure, the use to which the resulting revenues are to be put, and to a lesser extent the relief to be provided to tobacco farmers.

The number of proposals and proponents in the Senate requires something on the order of a football coach's sideline play sheet to keep straight. Senate Commerce Committee Chairman John McCain (R-Ariz.), in conjunction with Senate Judiciary Committee Chairman Orrin Hatch (R-Utah), is expected to take the lead in crafting the legislation, with mark-up of the legislation by the Senate Commerce Committee to begin as early as March 25. Senator McCain is also consulting with a bipartisan group of Senators, Sens. John Chafee (R-R.I.), Tom Harkin (D-Iowa), and Bob Graham (D-Fla.), who have developed a package that would put an $8 billion annual cap on tobacco industry payments of compensation and raise cigarette prices by $1.50 per pack over two years, but would not provide the broad immunity from lawsuits that the industry has been seeking. Further, Sen. McCain has been negotiating with the White House senior staff over provisions the Administration would find acceptable. Restrictions on tobacco industry advertising also are likely to be part of the mix.

The Senate Republican Leadership's plan is for Chairman McCain to report his proposal out of Committee and then to consider substitute amendments on the Senate Floor to hash out the final details of the package. No schedule has been set for Senate Floor action.

The House is much less far along. Rep. Vic Fazio (D-Sacramento) recently introduced a tough anti-tobacco package, along with 35 fellow Democrats, that raises the tobacco tax by $1.50 per pack, but contains none of the legal immunity provisions sought by the industry and lacks GOP support.

A significant number of Senators from both sides of the aisle remain troubled by the notion of providing limits on legal liability to the industry. Caps on annual payouts by the industry could emerge in compromise as a substitute for limits on liability. In addition, it seems likely that any legislation that emerges will provide a stiff per-pack increase in the tobacco tax. Restrictions on advertising and marketing, particularly aimed at preventing youth smoking, are likely to be part of any package.

Perhaps the principal obstacle to tobacco settlement legislation at this juncture is the Congressional calendar. There are on the order of 60 legislative days remaining in the session. While the Senate finally has begun moving to address in broad terms the key components of such a package, the effort is likely to give rise to a thousand fights over specifics among the numerous Senators who have staked out active positions on the key issues -- reminiscent of the adage that managing the Senate is like trying to herd cats.

We will continue to monitor developments for STRS.

John S. Stanton

Enclosures

March 17, 1998